Supreme Court, U.S.
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IN THE

Supreme Court of the United States

No. 71-522

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO UNITED STATES COURT OF CLAIMS

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IN THE

Supreme Court of the United States

No.

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO UNITED STATES COURT OF CLAIMS

St. Louis-San Francisco Railway Company prays that a writ of certiorari be issued to review the judgment of the United States Court of Claims entered in the above-titled case on July 14, 1971.

CITATION TO OPINION BELOW

The opinion of the Court of Claims dated July 14, 1971 (Appendix B, *infra*, at B-1) is reported at 444 F.2d 1102 (1971).

JURISDICTION

The judgment of the Court of Claims was entered on July 14, 1971. The jurisdiction of this Court rests on 28 U.S.C. Section 1255(1).

QUESTIONS PRESENTED

1. Whether a taxpayer sustains amortizable bond discount when it issues new bonds in exchange for its old bonds and preferred stock and the maturity value of the new bonds exceeds the fair market value of the old bonds and preferred stock exchanged therefor.

2. Whether for purposes of the Federal income tax, the fair market value of the stock and bonds regularly traded upon a national exchange is to be determined by reference to sales on that exchange.

3. Whether a taxpayer in its claim for refund must specifically allege the theory upon which it relies before a court may consider such a theory in a suit for refund of Federal income taxes subsequently instituted.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved are Sections 163 and 7422(a) of the Internal Revenue Code of 1954 (26 U.S.C. Sections 163 and 7422(a)) and Income Tax Regulations Section 1.163-3 promulgated by the United States Department of the Treasury. These sections are printed in Appendix A, *infra*, at A-1.

STATEMENT

Petitioner is a corporation organized and existing under the laws of the State of Missouri, and has its principal offices located in St. Louis. At all times here pertinent, petitioner was engaged in operating as a common carrier by

rail in interstate commerce and employed the accrual method of accounting.

1. Petitioner was reorganized, effective January 1, 1947, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and the Federal District Court having jurisdiction over petitioner's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under this reorganization plan, the outstanding common and preferred stock and the claims of unsecured creditors were eliminated as worthless and the holders of the several classes of long-term indebtedness and the bank creditors received new bonds, preferred stock, common stock and cash; certain equipment trust obligations were assessed; and the remaining previously outstanding indebtedness was canceled. Under the plan of reorganization petitioner issued new 4% First Mortgage Bonds and 4½% Second Mortgage Bonds having an aggregate maturity value of $120,935,000 but a market value, established by New York Stock Exchange quotations, totaling $91,866,411 in exchange for the outstanding old secured debt. Petitioner contends that it is entitled to amortize the difference of $29,068,589 between the maturity value of the new bonds and the fail market value of the old bonds as debt discount over the life of the new securities.

The court below rules that petitioner was not entitled to amortize the difference between the maturity value of the new bonds and the fair market value of the old bonds "because the maturity value of the new debt did not exceed the maturity value of the old debt." The court below relies upon its prior decisions in *Erie Lackawanna R.R. v. United States*, 422 F.2d 425 (Ct. Cl. 1970), and *Missouri Pacific R.R. v. United States*, 427 F.2d 727 (Ct. Cl. 1970), *modified on reconsideration*, 433 F.2d 1324 Ct. Cl. 1970), *cert. denied*, 301 U.S. 944 (1971).

2. In 1956, petitioner exchanged Series A, 5% Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for its outstanding Series A,

5% Preferred Stock, issued in the 1947 reorganization. The Internal Revenue Service ruled that this exchange was a reorganization under Section 368(a)(1)(E) of the Internal Revenue Code of 1954. For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture, one quarter share of common stock. They also received $5.00 cash for the dividend on the preferred stock which would have been due at the next dividend payment date had the preferred stockholder not surrendered his stock. In the aggregate, petitioner issued new debentures having a face value of $33,129,000, 82,823 shares of no par value common stock and cash in exchange for 331,290 shares of preferred stock, having a total par value of $33,129,000 but a market value, based on New York Stock Exchange quotations, of $22,908,148.35. Petitioner contends that it should be entitled to amortize the difference between the maturity value ($33,129,000) of new debentures issued and the fair market value of the preferred stock ($22,908,148.35) received in exchange for the new debentures as debt discount, and in any event, that it sustained debt discount upon the exchange to the extent of the value of the common stock and cash given up in the exchange.

The court below rules that petitioner was not entitled to amortize the difference between the maturity value of the new debt securities and the fair market value of the preferred stock nor did petitioner sustain debt discount to the extent of the value of the common stock given up in the exchange. The basis for the ruling was that where the maturity value of the new debt did not exceed the par value of the old preferred stock received in exchange for the new debt, no debt discount can arise, and, alternatively, by holding that the value to petitioner of the preferred stock received in the exchange for the debentures was significantly greater than what was initially paid in for the stock or its market value, relying upon its prior decisions in *Erie Lackawanna R.R. v. United States*, 422 F.2d 425 (Ct. Cl. 1970), and *Missouri Pacific R.R. v. United States*, 427

F.2d 727 (Ct. Cl. 1970), *modified on reconsideration*, 433 F.2d 1324 (1970), *cert. denied*, 402 U.S. 944 (1971). In addition, the court held that petitioner was not entitled to amortize debt discount measured by the value of the common stock given up in the exchange because common stock has no value in determining debt discount and, alternatively, because "it is very difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe, that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock)." Opinion, *infra*, Appendix B, at B-6, 7. The court concluded that petitioner was altering or repudiating its bargain to the detriment of the stockholders by seeking a tax deduction for the discount, citing *Bethlehem Steel Corp. v. United States*, 434 F.2d 1357 (Ct. Cl. 1970), and *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). No consideration was given by the court below to the cash consideration paid.

3. In 1959, 1960, and 1962, petitioner reacquired some of the debentures it issued in 1956 for preferred stock. Upon audit the Internal Revenue Service determined that petitioner realized gain on the reacquisition because the maturity value of the debentures was more than the retirement costs and unamortized issuance expenses. Petitioner properly elected to have any such gain excluded from income under the provisions of Internal Revenue Code Section 108(a) by filing Treasury Consent Form 982 and having the tax basis of its property reduced pursuant to Section 1017 by the amount of the gain so excluded from income. In its consent, petitioner requested that the gain, if any, reduce the basis of the preferred stock acquired through the issuance of the debentures. The Commissioner refused and reduced the basis of petitioner's property subject to ratable depreciation; he did not reduce the basis of petitioner's property subject to the retirement-replacement method of accounting. Petitioner contended,

among other things, that the Commissioner of Internal Revenue erred in failing to reduce the tax basis of all of petitioner's depreciable property as required by Treas. Reg. Section 1.1017-1(b)(7) and that the basis of petitioner's depreciable property subject to the retirement-replacement method of depreciation should have been reduced as well as the basis of property subject to retable depreciation.

The court below rules that because petitioner did not specifically allege as error in its claim for refund the failure of the Commissioner of Internal Revenue to reduce the basis of its property subject to the retirement-betterment method of depreciation, petitioner was foreclosed from asserting such an argument, citing, *United States v. Felt & Tarrant Manufacturing Co.*, 283 U.S. 269 (1931); *Union Pacific R.R. v. United States*, 389 F.2d 437 (Ct. Cl. 1968).

REASONS FOR GRANTING THE WRIT

I. THE 1947 REORGANIZATION AND THE 1956 EXCHANGE

1. The decision of the court below is in direct conflict with the decisions of the Tenth Circuit Court of Appeals in *Atchison, Topeka and Santa Fe R.R. v. United States*, 443 F.2d 147 (10th Cir. 1971), and of the Third Circuit Court of Appeals in *American Smelting & Refining Co. v. United States*, 130 F.2d 883 (3d Cir. 1942). In *Atchison, Topeka and Santa Fe* the taxpayer had issued bonds in exchange for the intangible claims of the general mortgage bondholders of a bankrupt predecessor company and the Government argued that debt discount does not arise in a bonds-for-property exchange. The court held, however, that debt discount could arise in such an exchange, citing *American Smelting & Refining Co., supra*, and *Nassau Lens Co. v. United States*, 308 F.2d 39 (2d Cir. 1962). In *American Smelting, supra*, the Third Circuit concluded that bonds issued in a face amount greater than the fair market value of the securities of its subsidiary, for which they were

issued, gave rise to amortizable discount in the amount of such difference.

The decision of the court below is also in direct conflict with the decision of the Second Circuit Court of Appeals in *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962).

The recent decision of the District Court in *Cities Service Co. v. United States*, 316 F. Supp. 61 (S.D. N.Y. 1970), further confuses this area of Federal tax law. In *Cities Service* the court held that debt discount can arise where the face amount of bonds issued for property is greater than the market value of the property acquired. However, where the property acquired is the issuer's own stock, a different rule is applied and no discount is allowed unless the issue price of the stock received in the exchange (i.e., the amount originally received upon the issuance of such stock) is less than the maturity value of the debentures issued in the exchange. See also the recent decision of *Claussen's, Inc. v. United States*, Civil No. 1350 (S.D. Ga., July 29, 1971).

The decision of the court below is in conflict with the basic long standing principle of the tax law that property received in an exchange is to be valued at its fair market value. See, e.g., *United States v. Davis*, 370 U.S. 65 (1962); Internal Revenue Code of 1954, 26 U.S.C. Sections 83, 119, 351(b), 356, 1001(b), 1031(b), 1038 and 1081(b). Where Congress has intended another standard to apply, it was expressly so stated. See, e.g., *id.*, sections 334(b), 358, 362, 372, 373, 374, 381, 1031(b), 1033(e), 1034(e), 1071, 1081 and 1102. The court below has created a new exception without legislative sanction to the general rule that fair market value is to be consulted in determining what is received in an exchange for purposes of measuring debt discount.

The court below also disregarded the proper standard for measuring gain where petitioner's securities were reacquired for an amount less than their face value. The court ruled

that gain was the difference between the face amount and the cost of reacquiring, even though the obligations were issued in exchange for property of a value considerably less than the face value of the obligations. The court's decision is therefore in direct conflict with *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962); *Bradford v. Commissioner*. 233 F.2d 935 (6th Cir. 1956); and *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932).

The court below again failed to recognize fair market value as a standard in the 1956 exchange when it failed to allocate the value of the preferred stock received in the exchange between the obligations, the common stock and the other element of the exchange, i.e., cash. *Natural Gas Pipeline Co. of America*, 45 B.T.A. 939 (1941); cf. *Copperhead Coal Co. v. Commissioner*, 272 F.2d 45 (6th Cir. 1959).

The court below ignored the Internal Revenue Code and the Treasury Department's long standing regulations on valuation by determining that the value of the property received in the exchange was what the property was worth to the issuer, without reference to the market quotations for that property. See Internal Revenue Code of 1954, 26 U.S.C. Section 2031(b) (1964); Treas. Reg. Sections 20.2031-2(b) and 25.2512-2. The Court of Claims has thus continued its divorce from the use of acceptable standards of the valuation of securities which began in *Erie Lackawanna R.R. v. United States*, 422 F.2d 425 (Ct. Cl. 1970), when it adopted the standard of "equitable equivalent" for valuing securities received in an exchange.

This Court should review this case to resolve the conflict between the Court of Claims and the various Circuit Courts of Appeals in the important question of when debt discount arises and how it is measured.

2. The question presented is clearly important to the administration of the tax laws. The strained money market of recent years has made the use of discount more preva-

lent in financing arrangements, particularly in the railroad industry, because of a lack of incentive for equity investment. The position adopted by the lower court in *St. Louis-San Francisco, supra,* is wholly inconsistent with the long-established Internal Revenue Service rules for determining the value of securities (cf., Internal Revenue Code, 26 U.S.C. Section 2031 (1964), Treas. Reg. Sections 20.2031-2(b) and 25.2512-2(b)). Recently enacted legislation with respect to debt discount (Tax Reform Act of 1969, 26 U.S.C. 1232(b) (1970)) has no effect upon security transactions prior to May 27, 1969. There is a lasting impact on taxpayers due to the fact that transactions not subject to the new legislation remain subject to audit by the Government because maturity dates and amortization periods of debt discount for securities issued prior to May 27, 1969, will extend for many years into the future and considerable litigation will result until this matter is resolved. See also Brief for United States in Opposition to Petition for Writ of Certiorari at 9, *Missouri Pacific R.R. v. United States,* October Term, 1970, No. 1333, *cert. denied,* 402 U.S. 944 (1971).

3. The need to clarify this area of the federal tax law is further pointed up by the decision of the Third Circuit Court of Appeals in *Montana Power Co. v. United States,* 232 F.2d 541 (3d Cir. 1956), *cert. denied,* 358 U.S. 842 (1958). This case dealt with the issuance of bonds for certain natural gas properties, and the court concluded that the discount was not available to the taxpayer since the fair market value of the assets for which the bonds were exchanged was not established. During the course of the opinion, in discussing the application of discount amortization to situations in which the securities are issued for property, the seven judges had four different opinions as to when discount was proper. Judges Maris, Goodrich and McLaughlin felt that bond discount was available when bonds were issued in a face amount in excess of the fair market value of the property for which they were exchanged. Judges Kalodner and Staley felt that bond

discount was not available where bonds were issued for property. Judge Hastie concluded that the discount was available when the bonds were exchanged for property but only in circumstances of arms length dealings. Chief Judge Biggs concluded that discount was available where bonds were issued for property even in the absence of a showing of fair market value of the property if a double tax would result in the absence of the allowance of a deduction for the discount.

The confusion in this area of the tax law, although having ramifications for all types of taxpayers, is particularly injurious to the railroad industry. As indicated by the divergent views and reasoning, relating to the debt discount problem, taken in the recent cases of *Atchison, Topeka and Santa Fe R.R. v. United States,* 433 F.2d 147 (10th Cir. 1971), *Cities Service Co. v. United States,* 316 F. Supp. 61 (S.D. N.Y. 1970), and *Claussen's, Inc. v. United States,* Civil No. 1350 (S.D. Ga., July 29, 1971), the problem is national in scope and requires additional sophisticated review and resolution. Over the years and particularly within the last two decades, a large number of railroads have had to undergo reorganizations in bankruptcy. Indeed, the extent of this phenomenon and the national concern involved finds recognition in the fact that special provisions have been enacted in the Bankruptcy Act (11 U.S.C. Section 205) to handle this class of person. As part of these reorganizations, new securities are invariably issued in exchange for the older outstanding classes of securities, with discount or additional interest being the inducement to the holders of the old securities to agree to the plan. Since discount is indigenous to railroad reorganizations, the tax impact of denying the deductions to the reorganized road during precarious post-reorganization periods defeats the purpose and hope of the reorganization.

The economic effect of the confusion in this area of law is particularly acute at this time due to the general liquidity problem that the railroad industry faces. The need to set aside funds to pay the additional taxes due from the dis-

allowance of amortization deductions diverts much needed cash from the operation of the roads.

Resolution of this issue would, therefore, have a salutory effect upon an important section of the economy.

4. It is petitioner's belief that the decision of the court below is erroneous and should be corrected by this Court.

The court below has confused debt discount for loss. What is involved here is the additional cost petitioner had to incur in addition to the interest specified in the obligation it was issuing. This additional cost was interest deductible over the life of the obligation. The substance of the transaction is no different than the borrowing of money by issuing bonds at a discount followed by the purchase of the old debt or old preferred stock at their respective fair market values. The court below admits that in this latter situation there is discount but refuses to see it where the new obligations are issued directly for the old, with the first step of issuing the bonds for cash being omitted. In treating the bonds and preferred stock of the issuer as a special class of property calling for special tax treatment, the court below has created an arbitrary distinction which confuses this area of tax law.

Reliance by the court below on such cases as *Bethlehem Steel Corp. v. United States*, 434 F.2d 1357 (Ct. Cl. 1970), and *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), is clearly erroneous and adds further confusion to the bond discount area. Both the *Bethlehem* and *Danielson* cases involved situations in which the tax consequences depended upon the characterizations in written agreements of payments made pursuant to those agreements. Debt discount by its nature is not made pursuant to a written agreement. It occurs simply by virtue of the fact that a purchaser will not pay face value for an obligation with the interest stated in the existing money market. Where a person pays less than the face amount for the bond, whether the medium of payment be money or other property, there is discount without regard

to whether or not there is a written agreement to the effect that discount is being paid. Tax consequences flow from economic reality and not from self serving opinions in written agreements.

The court below also erred in refusing to allow petitioner to amortize debt discount on the 1956 exchange measured by the value of the common stock and cash given in the exchange. In the 1956 exchange petitioner in order to induce the preferred stockholders to surrender their preferred stock for the debentures issued one quarter share of common stock and cash with each one hundred dollar ($100) maturity value debenture. The court below ruled that the value of the common stock given in the exchange should be ignored because petitioner made no definite future obligation in issuing such shares. However, common stock is property which has a value and when it is issued with debentures, debt discount exists to the extent of the fair market value of such stock. This is true because a portion of the preferred stock received in the exchange is exchanged for the common stock thereby reducing the amount of preferred stock received in the exchange for the debenture. *Natural Gas Pipeline Co. of America,* 45 B.T.A. 939 (1941), but see *Arkansas-Missouri Power Corp. v. Paschal,* 243 F.2d 584 (8th Cir. 1957), *cert. denied,* 355 U.S. 835 (1957). That principal also applies to the cash. The Court should resolve the conflict between the courts and the confusion on this important question of law.

II. THE REFUND CLAIM

What is involved in this portion of the proceeding is the standard to be applied in determining whether a claim for refund of Federal income taxes is sufficient to entertain a subsequent suit. In this case petitioner filed a claim for refund setting forth the specific facts in issue and alleged as error the Commissioner's action in reducing the basis of all of petitioner's ratably depreciable property pursuant to its election under Section 108(a) of the Code instead of

reducing the basis of the preferred stock received in exchange for the bonds which were the subject of the election. In the subsequent suit for the recovery of Federal income taxes based upon its refund claim, petitioner refined its theory of recovery over that specifically stated in its claim for refund by contending that if the basis reduction was not limited to the stock, then the basis of its property subject to the retirement-replacement method of accounting should be reduced proportionately along with that property subject to ratable depreciation.

The court below ruled that because petitioner did not specifically allege such a theory in its claim for refund, petitioner is foreclosed from presenting such a theory before the court, citing the prior decision of this Court in *United States v. Felt & Tarrant Manufacturing Co.*, 283 U.S. 269 (1931), and its own prior decision in *Union Pacific R.R. v. United States*, 389 F.2d 437 (Ct. Cl. 1968). In effect, the court below rules that unless a taxpayer specifically sets forth its theory of recovery in its claim for refund of Federal income taxes, it is foreclosed from recovery on such theory in its subsequent suit for the recovery of Federal income taxes.

The decision of the court below misapplies the principles established by this Court in *United States v. Andrews*, 302 U.S. 517 (1938); *United States v. Garbutt Oil Co.*, 302 U.S. 528 (1938); and previously decided cases. In these cases the Court decided that a refund claim may be amended if the amendment merely makes more definite the matters already within the Commissioner's knowledge but that a claim which demands relief upon one asserted fact situation cannot be amended to discard that basis and invoke action requiring examination of matters not germane to the original fact situation set forth in the claim.

In the instant case petitioner did not change the grounds upon which it sought recovery. In its claim for refund petitioner contested respondent's method of reducing the basis of petitioner's property. The claim for refund stated

that the basis for the specific property acquired should be reduced. Before the court below petitioner added the alternative that if the respondent was correct in ignoring the specific property acquired, then the basis for all of petitioner's depreciable property, retirement-betterment property as well as ratably depreciable property, should be proportionately reduced. Thus, the theory advanced by petitioner was not a new claim but was encompassed within the general framework of its original claim. It was necessarily a matter covered in the respondent's investigation of the original claim for refund. Indeed, it was the respondent's calculation made upon audit which was being questioned in petitioner's alternative theory. No further investigation was required. This Court should, therefore, accept jurisdiction of this case to correct the error of the court below, and to establish the standards which will guide taxpayers as to what is necessary for a refund claim and prevent the loss of substantial rights due to a too strict view of what is required to put the Commissioner of Internal Revenue on notice.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):

§ 163. INTEREST.

(a) GENERAL RULE.–There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

§ 7422. CIVIL ACTIONS FOR REFUND.

(a) NO SUIT PRIOR TO FILING CLAIM FOR REFUND.–No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard, and the regulations of the Secretary or his delegate established in pursuance thereof.

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.163-3. DEDUCTION FOR BOND DISCOUNT.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3).

APPENDIX B

In the United States Court of Claims

No. 289–65

No. 303–66

(Decided July 14, 1971)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

George K. Dunham, for plaintiff. *Robert T. Molloy*, attorney of record. *George E. Bailey* and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walker*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT RESPECTING THE DEBT DISCOUNT ISSUE AND DEFENDANT'S CROSS MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

These cases come before the court on cross-motions for partial summary judgment. Plaintiff is seeking tax refunds for the years of 1953 through 1961. At issue in this proceeding are the years 1955 through 1961. The main question before us now is the troublesome one of the existence and measurement of debt discount when a corporation exchanges new debt obligations for its outstanding debt obligations and its outstanding stock. Since two exchanges are involved, we will consider each separately before discussing the other issues raised in the parties' motions.

I

The 1947 Reorganization

In 1947 plaintiff St. Louis-San Francisco Railway Company underwent a reorganization pursuant to Section 77 of the Bankruptcy Act.[1] Under the plan adopted, plaintiff exchanged new stock, new bonds, and cash for outstanding bank loans, bonds, and accrued interest.[2] Before the exchange, the face value of this outstanding debt and interest totaled $363,789,651. Plaintiff gave up in the exchange securities having a maturity value and a par value of $244,856,494. The aggregate maturity value of the new bonds totaled $120,935,000, and their market value, as established by New York Stock Exchange quotations, totaled $91,866,411. A schedule of the reorganized company shows that in no instance did the face value of the bonds issued exceed the principal amount of the old debt. See *McCullough* v. *United States*, 170 Ct. Cl. 1, 24–25, 344 F. 2d 383, *cert. denied*, 382 U.S. 901 (1965). Plaintiff tells us that the market value of the old debt equaled $91,866,411. The figure was apparently computed on plaintiff's assumption that fair market value equivalents were exchanged.

Plaintiff contends that it is entitled to amortize the difference between the maturity value of the new bonds and the fair market value of old debt as debt discount. This difference, according to plaintiff, would be $29,068,689, amortizable over the life of the bonds. Plaintiff relies on Treasury Regulation 1.163–3 and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3rd Cir. 1942). In the alternative, plaintiff argues that a trial would be necessary if we adhere to our decisions in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970) and *Missouri Pac. R.R.* v. *United States*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), *modified on reconsideration*, 193 Ct. Cl. 257, 433 F. 2d 1324 (1970), *cert. denied*, 39 U.S.L. WEEK 3486 (May 3, 1971).

On the other hand, defendant says that fair market value is irrelevant when the corporation exchanges its own debt

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[1] Plaintiff is an accrual basis taxpayer for the years in question.

[2] Claims of the common and preferred stockholders and unsecured creditors were eliminated from the capital structure as worthless.

obligations. Defendant further contends that no trial is necessary, because the undisputed facts establish that no discount arose in the exchange. For both arguments, defendant relies on *Missouri Pacific*, *supra*.

After a review of our decisions in *Erie Lackawanna* and *Missouri Pacific*, we find no reason to change the rules set forth in those cases with respect to the existence and measurement of debt discount when a corporation issues new bonds in exchange for its outstanding debt. In this case, the plaintiff engaged in a reorganization—a recapitalization in which no new capital or assets were added. The secured creditors received new bonds, preferred stock, common stock and cash. The maturity value of the new bonds was less than the face value of the old bonds.

In *Missouri Pacific*, *supra*, we held contrary to the position now taken by plaintiff with reference to the use of fair market value for measuring debt discount. In that case, we said "The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities." 192 Ct. Cl. at 324, 427 F. 2d at 731. Applying the rule announced in that case, we find that no debt discount arose in the 1947 reorganization, because the maturity value of the new debt did not exceed the maturity value of the old debt. There is no dispute about that fact and thus no trial is necessary. Since plaintiff incurred no discount in the issuance of the new bonds in the 1947 reorganization, it is entitled to no deductions for the claimed discounts during the years in suit.[3]

II

The 1956 Exchange

In 1956 plaintiff exchanged Series A, five percent Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for its outstanding Series A, five percent Preferred Stock, issued in the 1947 reorganization.

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[3] On the assumption that the bonds issued in 1947 were issued at a discount, plaintiff makes certain additional claims. However, we need not consider these, because plaintiff concedes (page 26 of its Reply Brief) that a decision that the bonds were not issued at a discount precludes recovery on the additional claims.

For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture, one quarter share of common stock, and cash amounting to the unpaid portion of the dividend on the preferred stock.

In the aggregate, plaintiff exchanged debentures having a face value of $33,129,000 and 82,823 shares of no par common stock for 331.290 shares of preferred stock which had a total par value of $33,129,000. The market value of the preferred stock, based on New York Stock Exchange quotations, averaged $22,908,148.35 over the period of the exchange. After the exchange was completed, the preferred stock was cancelled and retired.

This transaction was considered by the Internal Revenue Service a reorganization under Section 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under section 368(a)(1)(E).

In claiming that the 1956 exchange gave rise to amortizable debt discount, plaintiff's primary contention is that the fair market value of the preferred stock ($22,908,148.35) subtracted from the maturity value of the debentures ($33,129,000) is the measurement of debt discount. Thus, plaintiff has computed an amortizable discount of $10,220,851.65.

Plaintiff does not contend that the maturity value of the debentures issued in 1956 exceeded the amount it received when it issued the preferred stock in the 1947 reorganization. Indeed, the facts show that in the 1947 reorganization, plaintiff issued the preferred stock (received in the 1956 exchange), plus common stock and two issues of new bonds having a combined maturity, par, or stated value of approximately $244,856,000 in satisfaction of claims totaling $363,789,000—an amount which exceeded the par and stated value of the stock and bonds issued in 1947 by more than $100,000,000.

The question as to whether original debt discount arises when there is an exchange of debt for equity has been before the court twice in recent years. In *Erie Lackawanna*, we rejected the use of fair market value as a determinative measurement of debt discount when bonds were exchanged for preferred stock. The key element in that case was the *value*

to the corporation of the stock received in the exchange and that value was what had been paid in for the stock. Since the preferred stock in that case had been issued in exchange for the cancellation of debt equal to the par value of the stock, we held that when $100 par value shares were exchanged for $100 maturity value debentures, equivalents had been exchanged and no discount could be said to arise.

In *Missouri Pacific*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), where bonds were exchanged for stock, we adhered to our decision in *Erie Lackawanna* by stating that when bonds are issued in exchange for stock, debt discount is to be measured by the difference between the face value of the new bonds and the amount originally paid for the stock. On reconsideration (193 Ct. Cl. 257, 433 F. 2d 1324 (1970)), we further refined the measurement by deciding that the amount originally paid in for the stock was the floor in computing debt discount but that the stock could have a greater value in the eyes of the corporation. This greater value was to be determined only after consideration of relevant information, including the market value of the stock, the financial conditions of the taxpayer at the time of the exchange, profit prospects, and expert opinion.

Plaintiff has argued that if we adhere to our decision on reconsideration in *Missouri Pacific*, *supra*, and reject the use of fair market value in determining debt discount, we should order a trial to determine the amount actually paid in for the preferred stock. We again reject the fair market value of the preferred stock in this type of transaction as determinative of the value of the shares to the corporation.

However, no trial is needed, because it is established here, as in *Erie Lackawanna*, that there was an exchange of equals, and as in *Erie Lackawanna*, plaintiff in the 1956 exchange got back one $100 par value share of preferred stock for each $100 debenture given up. Accordingly, plaintiff is entitled to no deduction on account of a claimed discount arising out of the 1956 exchange.

We would reach the same result by holding that the value to plaintiff of the preferred stock, received in exchange for the debentures, was significantly greater than what was initially paid in for the stock or its market value as shown

by stock market quotations at the time of the exchange. In *Missouri Pacific* we said that all relevant factors, including the financial condition of the corporation, should be considered. The plaintiff reported to its shareholders that the exchange would increase its after-tax earnings by over $800,000 per year, without considering any saving due to a determination that it incurred debt discount. Considering this factor, we think that a receipt of stock that increased plaintiff's after-tax earnings by more than $800,000 per year cannot be said to be worth less than the face value of the bonds exchanged for the stock.

Plaintiff makes an additional argument with respect to the common stock, which in addition to the debentures, was exchanged for the preferred stock in the 1956 transaction. Plaintiff says that if it is assumed that each share of the preferred stock had a value of $100, plaintiff incurred debt discount in the amount of the value of the common stock given up in the exchange. Thus, plaintiff contends that if each share of common stock was worth $10, the debt discount should be computed by multiplying the total number of shares of common stock by $10.

Wholly apart from our alternate holding on the 1956 transaction, we find that this contention is without merit. In *Missouri Pacific*, we eliminated the value of new stock which, in addition to bonds and notes, was given in exchange for the corporation's outstanding debt securities and stock from consideration in determining debt discount, 192 Ct. Cl. at 321, n. 4, 427 F. 2d at 729, n. 4. In an analogous situation, we ignored the issuance of preferred stock in determining whether there was a carry-over of debt discount and compared only the maturity value of new bonds and cash with the face value of the old bonds given up in the exchange. *Chicago, Milwaukee R.R.* v. *United States*, 186 Ct. Cl. 250, 263, 404 F. 2d 960, 967 (1968).

Common stock is not a fixed debt obligation, and the plaintiff made no definite obligation for the future by issuing those shares.

In addition, it is very difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe,

that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock). The taxpayer cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself. *Cf. Bethlehem Steel Corp* v. *United States*, 193 Ct. Cl. 459, 434 F. 2d 1357 (Dec. 11, 1970); *Commissioner* v. *Danielson*, 378 F. 2d 771, 775 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967).

III

The Reacquisition of Debentures

In 1959, 1960, and 1962,[4] plaintiff reacquired some of the debentures it issued in 1956 for preferred stock. The Internal Revenue Service on audit determined that plaintiff realized a gain on these transactions. The gain was computed on the basis of the maturity value of the debentures less retirement costs and unamortized issuance expense. The plaintiff elected to have these gains excluded from income under section 108(a) and signed Treasury Consent Forms 982 to have the tax basis of its property reduced pursuant to section 1017 by the amount of the gains so excluded from income.[5] In the consent, plaintiff requested that the gain, if

[4] The issues relating to 1962 are based on a carryback loss from 1962 to 1961 and are included in plaintiff's 1961 refund claim.

[5] Sections 108 and 1017 read:

"§ 108. INCOME FROM DISCHARGE OF INDEBTEDNESS

(a) *Special rule of exclusion.*—No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortised discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction."

• • • • •

Footnote continued on p. 8.

any, reduce the basis of the preferred stock acquired through the issuance of the debentures. The Commissioner of Internal Revenue refused and reduced the basis of plaintiff's property subject to ratable depreciation. The Commissioner did not reduce the basis of plaintiff's property which was subject to the retirement-replacement method of depreciation.

Plaintiff first argues that the issue price of the debentures controls the computation of gain. We agree. The actual issue price, the value of what plaintiff received for the debentures, controls any determination of gain on the cancellation of indebtedness. Treas. Reg. 1.61–12(c); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Fashion Park, Inc.* 21 T.C. 600 (1954).

However, we have already found that the issue price of the bonds was their maturity value. The value of the stock received by the plaintiff was equivalent to the maturity value of the bonds. Therefore, the Service properly computed the gain on the cancellation of indebtedness.

Plaintiff next argues that these gains should be applied to reduce plaintiff's basis in the preferred stock, the specific property for which the debentures were issued. Treas. Reg. 1.1017–1(a)(1). However, section 1017 clearly requires that the property be held or acquired during the tax year the income is realized. Here the preferred stock was no longer in existence for the years 1959, 1960, and 1962, because it was cancelled or retired immediately after the completion of the 1956 exchange.

Plaintiff's third contention on this issue is that the Commissioner of Internal Revenue erred in failing to reduce the

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Footnote 5—Continued

"§ 1017. DISCHARGE OF INDEBTEDNESS

Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108(a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began."

tax basis of all depreciable property owned by it, as required by Reg. 1.1017-1 (b) (7). It is contended that the retirement-replacement method of accounting (which plaintiff uses) is a form of depreciation. Therefore, plaintiff maintains that the Commissioner erred in reducing only the basis of property subject to ratable depreciation.

Defendant counters with two arguments—one attacking the claim on substantive grounds and the other alleging a procedural defect. We do not reach the substantive issue because we find, as defendant contends, that plaintiff did not assert this ground for recovery in its administrative claim for refund and thus cannot now raise it. Section 7422; *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U.S. 269 (1931); *Union Pac. R.R.* v. *United States*, 182 Ct. Cl. 103, 389 F. 2d 437 (1968).

In its claim for refund before the Commissioner of Internal Revenue for 1961 (which is representative), plaintiff sought:

> In each of the aforesaid years taxpayer filed Consent Form 982, electing to exclude the alleged profit set forth above under Section 108(a) and to reduce the basis of property under Section 1017 of the Code. In said Consent, taxpayer stated that it did not concede that the issue price of the debentures was equivalent to the face amount thereof. Taxpayer further requested that the gain, if any, resulting from the acquisition of the Debentures, as finally determined by agreement with the Internal Revenue Service or by a court of competent jurisdiction, should be applied to reduce basis of the specific property acquired; i.e., the Preferred Stock. The Examining Agent refused to reduce the basis of the specific property acquired as requested by taxpayer and, in lieu thereof, applied the general rule and reduced the basis of all of taxpayer's depreciable property to the extent of the amounts of "profit" set forth above. As a result of such reduction in basis, the Examining Agent disallowed deductions for depreciation as follows:
>
> | | |
> |---|---|
> | 1959 | $9,367.70 |
> | 1960 | 9,314.09 |
> | 1961 | 7,949.38 |
> | 1962 | 21,521.89 |
>
> It is the contention of taxpayer that the action of the Examining Agent as explained above was erroneous,

and that it is entitled to the deductions for depreciation improperly disallowed as aforesaid. * * *

A careful reading of the claim for refund shows that plaintiff asserted that the error of the Internal Revenue Service was its refusal to reduce the basis of the specific property acquired, *i.e.*, the preferred stock, and that the reduction in the basis of "all of plaintiff's depreciable property" to the extent of the profit plaintiff made on the acquisition of the debentures resulted in an improper disallowance of deductions for depreciation. This is the only ground of complaint; there is no suggestion that the Internal Revenue Service erred in reducing the basis of some but not all of plaintiff's depreciable property, or more specifically that the Service erred in not reducing the basis of plaintiff's property subject to the retirement-replacement method of depreciation. In our opinion, the allegations in the claim for refund were insufficient to call the Commissioner's attention to the potential ground for recovery now urged upon us, or to state the facts which would enable the Commissioner to discover for himself and correct what is now claimed to be erroneous action.

It is not determinative of the issue, but the fact that this ground for recovery is not mentioned or referred to in plaintiff's petition is an indication that it was not included in the claim for refund.

The reasons for requiring a ground for refund to be raised first before the Internal Revenue Service were explained in *Union Pac. R.R.* v. *United States*, *supra*:

> It is an undisputed general rule that a ground for refund neither specifically raised by, nor comprised within the general language of, a timely formal or informal application for refund to the Internal Revenue Service cannot be considered by a court in which a suit for refund is subsequently initiated. * * * The rule that a taxpayer cannot present one ground for refund in its claim and a different ground in its petition is designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. * * * In addition, the Commissioner is provided with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing

> litigation to those issues which have been examined and which he is willing to defend. * * * (182 Ct. Cl. at 108, 389 F. 2d at 442) [citations omitted]

Therefore, as a result of the omission in plaintiff's refund claim, the claim cannot now be considered.

IV

Plaintiff's Alternative Contention on the Debt Discount Issue

Plaintiff's final argument is that if it should be denied the right to amortize the debt discount it claims with respect to the 1947 and 1956 transactions, it should nevertheless be permitted to add the claimed debt discount to the cost basis of its depreciable property. The entire argument is predicated on the assumption that plaintiff actually incurred debt discount in the transactions mentioned. Since we have held to the contrary, this claim must also be denied.

V

Conclusion

For the reasons stated above, plaintiff's motion for partial summary judgment is denied. Defendant's motion for partial summary judgment is granted, and to the extent that plaintiff's claims are covered by the foregoing opinion, such claims in plaintiff's petitions are hereby dismissed.

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In the Supreme Court of the United States

OCTOBER TERM, 1971

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-522

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. B 1-11) is reported at 444 F. 2d 1102.

JURISDICTION

On July 14, 1971, the Court of Claims granted the government's motion for partial summary judgment and dismissed petitioner's claims to the extent that they are inconsistent with the court's opinion

(Pet. App. B 1, 11). The petition for a writ of certiorari was filed on October 12, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1255 (1).

QUESTIONS PRESENTED

1. Whether petitioner incurred amortizable bond discount in a 1947 reorganization under Section 77 of the Bankruptcy Act when it issued new bonds and stock in exchange for outstanding bonds and cancellation of bank loans, and the maturity value of the new bonds was less than the principal amount of the total old debt.

2. Whether petitioner incurred amortizable bond discount in 1956 when it issued new debentures and common stock in exchange for old preferred stock which had been issued in the 1947 reorganization, where the maturity value of the new debentures was equivalent to the par value of the old preferred stock, and petitioner had received more than full consideration for the issuance of the latter.

3. Whether the court below properly refused to consider on its merits a contention not raised by petitioner in its claims for refund.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutory and regulatory provisions are set forth in Appendix A to the petition (Pet. App. A 1).

STATEMENT

The exchange of bonds for debt in the 1947 reorganization

In a 1947 reorganization under Section 77 of the Bankruptcy Act (11 U.S.C. 205), petitioner issued its new bonds, stock and cash in exchange for its outstanding bonds and cancellation of bank loans, plus accrued interest ("old debt"). The face value of the old debt was $363,789,651. The maturity and par value of the new securities was $244,856,494, of which $120,935,000 was the maturity value of the new bonds. At the time of the 1947 exchange, the market value of the new bonds, as quoted on the New York Stock Exchange, was $91,866,411. (Pet. App. B 2-3.)

Petitioner argued that the market value of the old debt was established by the quoted value of the new bonds, on the assumption that fair market value equivalents were exchanged, and contended that the difference between the value thus attributed to the old debt ($91,866,411) and the maturity value of the new bonds ($120,935,000) constituted amortizable bond discount. The court held that there was no discount because petitioner gave up no more value than it received when it issued new bonds having a maturity value less than the maturity value of the old debt that was cancelled. (Pet. App. B 2-3.)

The 1956 exchange of debentures and common stock for preferred stock

In the 1947 reorganization, petitioner had issued five percent preferred stock with a par value of $33,129,000. In 1956, in a recapitalization described in

Section 368(a)(1)(E) of the Internal Revenue Code of 1954, petitioner exchanged five percent debentures with a maturity value of $33,129,000, plus 82,823 shares of no par common stock, for the five percent preferred stock, which was cancelled and retired. The holders of the preferred stock thus received a $100 maturity value debenture for each $100 par value share of preferred stock surrendered, plus one-quarter share of common stock. (They also received in cash the unpaid portion of accrued dividends on the preferred stock.) At the time of the 1956 exchange, the market value of the old preferred stock, as quoted on the New York Stock Exchange, averaged $22,908,148.35. (Pet. App. B 3-4.)

Petitioner contended primarily that the difference between the market value of the redeemed preferred stock ($22,908,148.35) and the maturity value of the new debentures ($33,129,000) constituted amortizable bond discount. The court, noting (Pet. App. B 4) that the maturity value of the new debentures was less than the consideration received by petitioner on issuance of its preferred stock in 1947, held (Pet. App. B 5) that no discount was incurred in the exchange of debentures for the preferred stock, since "there was an exchange of equals" in which petitioner "got back one $100 par value share of preferred stock for each $100 debenture given up."

Petitioner also contended that, even if the preferred stock had the same value as the new debentures, it incurred bond discount to the extent of the value of the new common stock issued in the 1956 exchange. The court rejected this contention on the

ground that the issuance of common stock does not create a definite repayment obligation that can give rise to bond discount expense (Pet. App. B 6). Finally, the court pointed out that if petitioner was entitled to bond discount deductions, the preferred stockholders would, as a necessary corollary, realize interest income. But the court found that the preferred stockholders neither believed, nor were given reason to believe, that they would be realizing interest income by reason of the issuance of common stock, and held (Pet. App. B 7) that petitioner "cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself."

The sufficiency of petitioner's claims for refund with respect to another issue

In 1959, 1960 and 1962, petitioner realized gains when it reacquired for less than face value some of the debentures issued in 1956. As permitted by Section 108(a) of the Code, petitioner elected to have these gains excluded from income and applied in reduction of the tax basis of its property. The Commissioner determined that the gains on reacquisition should reduce the basis of so much of petitioner's property as was subject to ratable depreciation. In its claims for refund and complaint, petitioner asserted only that the gains should reduce the basis of the preferred stock surrendered and cancelled in the 1956 exchange. (Pet. App. B 7-10.)

Petitioner contended for the first time on brief that if the basis of depreciable property, rather than

preferred stock, was to be reduced, the reduction should not be limited to property subject to ratable depreciation, but should also include property subject to the retirement-replacement method of accounting. The court ruled that the gains could not be applied in reduction of the basis of the preferred stock because that stock had ceased to exist in 1956. It refused to consider petitioner's alternative argument on the merits because it had not been raised in the claims for refund. (Pet. App. B 8-10.)

ARGUMENT

The decision below is correct. There is no direct conflict on any of the issues raised, and no other reason for further review.

1. The question whether petitioner incurred bond discount in the 1947 reorganization is essentially the same as the issue raised in *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified on reconsideration, 433 F. 2d 1324 (Ct. Cl.), certiorari denied, 402 U.S. 944. We discussed the nature of bond discount at length in our brief in opposition in that case (No. 1333, 1970 Term), on which we here rely.[1] It is sufficient to reiterate as a general matter only that bond discount ordinarily arises where bonds are issued for a cash amount which is less than the face amount of the bonds; that it is amortizable by the issuer ratably over the life of the bonds as the

[1] Copies of the brief were served on counsel for petitioner herein, who also was counsel for the taxpayer in *Missouri Pacific*.

equivalent of additional interest expense; and that its accrual or receipt by the bondholder is treated as additional interest income. See *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54.

In 1947, petitioner issued new bonds in exchange for its old debt of equivalent or greater maturity value, but obtained no new capital in the transaction. It contends (Pet. 11) that it should be treated as if it had issued the new bonds for cash, and then used the proceeds to buy back the old debt in a separate transaction, with the result that it incurred discount measured by the excess of the face amount of the new bonds over the fair market value of the old debt. But this Court has refused to apply petitioner's two-step analysis in similar circumstances, and has held instead that there was a mere substitution of obligations which required the debtor corporation to carry over unamortized discount on the old bonds and to amortize it over the life of the new securities. *Gt. W. Power Co.* v. *Commissioner*, 297 U.S. 543, 546.

This rationale is applicable here. Where, as here, a corporate debtor issues new bonds in substitution for old bonds of equivalent or greater maturity value, bond discount cannot be determined by reference to the market value of the old debt which is extinguished in the exchange. This value is meaningless to the debtor because the old debt is no longer subject to market conditions, and the debtor is in no worse position after the exchange than it was previously—the amount of its assets has not been reduced,

and its obligation to pay has not been increased. To recognize bond discount in these circumstances would permit a corporate debtor to generate income tax deductions merely by a paper reshuffling of its financial structure, but without any real change in that structure. It would "give credence to an illusional or fictional interest charge which does not actually exist. * * * [Petitioner] would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations." *Missouri Pacific Railroad Co.* v. *United States*, *supra*, 427 F. 2d at 731.

2. For similar reasons, bond discount on the 1956 exchange cannot be determined by reference to the fair market value of the preferred stock surrendered in the exchange. This value is as meaningless to petitioner as the value of the old bonds surrendered in 1947. The critical fact is that petitioner merely reshuffled its financial structure by substituting a $100 debenture for each $100 par value of preferred stock previously outstanding. As the court below recognized (Pet. App. B 4-5), this was an exchange of equivalents so far as petitioner was concerned. Given the fact that the consideration received by petitioner upon issuance of the preferred stock in 1947 was equal to, or in excess of, the maturity value of the new bonds, it suffered no loss and no actual or anticipated expense when it issued the new bonds. It follows that petitioner did not incur bond discount in the 1956 transaction.[2] See *Erie Lackawanna R.R.*

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[2] The Court of Claims alternatively reached the same conclusion (Pet. App. B 5-6) in reliance on the fact that petitioner had represented to its shareholders that the 1956 ex-

v. *United States*, 422 F. 2d 425 (Ct. Cl.); *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner*, 57 T.C. No. 6, decided October 14, 1971.

Contrary to petitioner's assertions (Pet. 8, 12), it is immaterial that cash and common stock were issued, together with bonds, in the 1956 exchange. The cash was only the unpaid portion of the dividends on the preferred stock (Pet. App. B 4), and did not represent a reduction in petitioner's assets attributable to the redemption of such stock. Nor were petitioner's assets reduced or its obligation to pay increased by the issuance of common stock, since the latter, by its very nature, is not a fixed obligation which increases corporate indebtedness. At all events, as the court below explained (Pet. App. B 6-7), it would be unfair to allow petitioner to obtain a tax advantage in the form of bond discount deductions, which would require as a consequence that the old preferred stockholders realize additional interest income, when petitioner gave them no reason to believe that a discount arose as a result of the issuance of common stock. See *Commissioner* v. *Danielson*, 378 F. 2d 771 (C.A. 3), certiorari denied, 389 U.S. 858;

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change would increase its after-tax earnings (available to common stockholders) by more than $800,000 per year. (The projected increase results from the fact that the five percent stated interest on the new bonds would be deductible and would produce a tax benefit, while the five percent dividend on the same face amount of preferred stock was not deductible.) The court reasoned that since the effect of the exchange was to increase petitioner's earnings substantially, the stock received by petitioner could not be worth less to it than the face amount of the debentures issued, and therefore, that no discount was incurred.

Bethlehem Steel Corp. v. *United States*, 434 F. 2d 1357 (Ct. Cl.).

3. There is no conflict with *Atchison, Topeka and Sante Fe R. Co.* v. *United States*, 443 F. 2d 147 (C.A. 10), as petitioner claims (Pet. 6). In that case, the Tenth Circuit determined bond discount by reference to the market value of the old securities. But the facts were not comparable to those here. *Atchison* involved an 1895 equity reorganization in which the predecessor and successor companies were different corporate entities. There was an exchange of the bonds of one taxpayer for the assets or securities of another, not a mere substitution of securities within a single corporation. And the Tenth Circuit pointed out that the transaction there in question predated the enactment of the income tax laws, so that the parties, at the time of the transaction, did not have competing tax interests. These considerations and others led the Tax Court recently to conclude in a unanimous reviewed opinion in *National Alfalfa, supra*, that the holding in *Atchison* did not apply in a transaction identical in all salient respects to petitioner's 1956 exchange. Appeal in *National Alfalfa* lies to the Tenth Circuit. To the extent, therefore, that petitioner relies on the views of the Tenth Circuit to establish conflict, it will be time enough to consider whether review by this Court is appropriate if the decision in *National Alfalfa* is reversed.

There is likewise no conflict with *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3). Although, as petitioner points out (Pet. 6-7), the court there valued stock for which new

bonds were issued by reference to market quotations, the facts again are significantly different from those in the instant case. *American Smelting* involved an exchange of the taxpayer's bonds for the preferred stock of its subsidiaries—not, as here, substitutions of the issuer's bonds for its own debt and securities of equal or greater value. Moreover, *American Smelting* was decided before this Court held in *United States* v. *Midland-Ross Corp.*, *supra*, that, to the extent of discount, a bondholder realizes a corresponding amount of interest income. It is doubtful whether the Third Circuit would reach the same result today, in the light of *Midland-Ross* and its own subsequent ruling in *Commissioner* v. *Danielson*, *supra*, that it is not the function of the courts to fashion a new bargain for parties to a contract who have competing tax interests. In *American Smelting*, the parties made no provision for bond discount.

There is not even an arguable conflict with *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (C.A. 2), upon which petitioner also relies (Pet. 7). In that case the taxpayer purchased inventory at an agreed price of $100,000, issuing therefor one hundred $1,000 debenture notes. Each note provided for yearly increases in the redemption price. These increases obviously represented the cost of borrowing rather than payment of the agreed purchase price, and the court properly held that the increases constituted amortizable discount.

4. As petitioner notes (Pet. 9-10), and as we acknowledged in our brief in opposition in *Missouri Pacific Railroad Co.* v. *United States*, *supra*, there is

some confusion among the courts concerning the circumstances under which bond discount may be incurred. The matter continues to be of administrative importance notwithstanding the provisions added to the Internal Revenue Code by the Tax Reform Act of 1969 as to bonds issued after May 27, 1969 (Section 1232(b) of the Code, as amended by Section 413(b) of P.L. 91-172, 83 Stat. 609). But this is not an appropriate case for certiorari because it is clear that petitioner did not issue new bonds with a value greater than the value to it of its old securities. Hence, under any theory, petitioner did not incur bond discount expense as a result of either the 1947 or 1956 transaction.

5. Finally, petitioner contends (Pet. 12-14) that the court below erred in holding that its claims for refund did not set forth its alternative ground for recovery in connection with the allocation of basis adjustments. This issue, turning as it does on a reading of the claims for refund, and the question whether the language of the claims was sufficient to call the Commissioner's attention to the alternative ground for recovery, is not worthy of this Court's review. In any event, the court below, after carefully considering the claims, and noting that petitioner did not refer to the alternative argument either in the claims or in its complaint, correctly held (Pet. App. B 7-11) that the claims were insufficient, and, therefore, that petitioner was barred from raising the issue on brief. See *Real Estate-Land Title & Trust Co.* v. *United States*, 309 U.S. 13; *United*

States v. *Garbutt Oil Co.*, 302 U.S. 528, 531-532; *United States* v. *Andrews*, 302 U.S. 517 .

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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